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Low Expectations, High Growth: China's Economy in 1987

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Low Expectations, High Growth: The Economy and Reform in 1987

Penelope B. Prime

The political roller coaster China rode in 1987 also proved unsettling for the economic reforms. Assurances that the reforms would continue and the appointment of Zhao Ziyang to replace Hu Yaobang as the Party general secretary gave little solace initially. Following Hu's resignation, expectations concerning the acceleration, or even the maintenance, of China's reform program fell. Major reform initiatives such as the proposed bankruptcy law were put on hold. Debate ensued over the effect on socialism of separating management from ownership, decreasing the role of the Party and ministries in enterprise operations, altering relative prices through price reform, and allowing income inequalities to widen. Periodic attacks by Party conservatives on influential intellectuals who had openly expressed their liberal ideas added to the atmosphere of uncertainty. By year's end, however, hints of the compromises reached at the Party retreat held in Beidaihe in August were confirmed by a strong pro-reform stance taken at the Thirteenth Party Congress held in October. Reform had won the day, although the victory had not been easy.

In the midst of uncertainties concerning the future of reform, the economy began to exhibit serious macroeconomic imbalances. Economic growth was steady at the start of 1987, and then it began to take off.¹ By mid-year, accelerating growth was accompanied by inflation and over-investment in some sectors, causing the government to re-impose price and investment controls. Ironically, although the continuation of economic reforms was endorsed by the Thirteenth Party Congress, the strains of macroeconomic imbalances may now stand in the way of their implementation.

¹ Unless otherwise noted, statistics on China's economic performance are from *Beijing Review*; *Foreign Broadcast Information Service (FBIS)*, *China Daily Report*, and *Xinhua*.

China's experiment with a wide variety of changes in economic policy and the economic system, collectively referred to as economic reform, has been going on since 1979. Compared with the economic system in place before 1979, many of these reforms represent radical shifts in the levels of decision making and the use of incentives. Changes were often implemented first on a trial basis in one region, city, or group of enterprises. If the trial reform proved to be successful, then the central economic offices encouraged general implementation. Also, rather than trying too many changes at once, the Party has introduced reforms gradually. Because of this approach, however, compatibility and uniformity have been lacking during this transitional period, and this has allowed the process of implementation to disrupt the overall balance of the economy.

Such disruption serves as ammunition for political conflict over both the implementation process and the reforms themselves. Although most of the resulting problems in the economy are due to the nature of the transition and not to the fact that particular reforms are necessarily failing, and despite the fact that the problems are temporary, they create pressure for retreat. This pressure comes both from people unsympathetic to the reform effort and from those who favor changes in the process to ease the economic dislocations and thereby to prevent the reforms from being abandoned altogether. The overall goal of the reforms is to replace administrative controls with a system that utilizes indirect influences over the economy such as price and tax incentives. When imbalances result, the most expedient solution is to reimpose administrative controls. Such controls, however, are directly opposite to the goal of reform, and once imposed, they are not easily removed. For example, between 1980 and 1982 and again in 1985, administrative measures put in place in response to shortages, inflation, and domestic and international deficits took precedence over reform.

Economic Growth in 1987

Many of these same imbalances were again problematic in 1987. Inflation was higher than in 1986, shortages of food emerged, and over-investment in some sectors continued to occur—all familiar problems in past periods when the economy "overheated." In addition, state revenues continued to decline as a proportion of national income as a result of the reforms. At mid-year national government revenues were 1.7 percent below planned levels.

However, two important results of the reforms countered the imbalances: a near-record grain harvest and a reduction in the trade deficit.

The harvest reached 402 million tons, representing a 2.8 percent increase over 1986 and second only to the record harvest of 405 tons in 1984. By promoting exports and restricting imports, China ended 1987 with a trade deficit of \$3.5 billion after two years of substantially larger deficits. Both the good harvest and the improved trade balance will give China some maneuverability in 1988 to deal with the tensions resulting from imbalanced growth. A good harvest ensures plentiful food supplies to urban workers without necessitating grain imports, and it provides fodder for other food production such as meat and dairy products. The improved trade balance means central officials can consider easing restrictions on capital imports to upgrade technology and lessen the demand for domestic inputs.

Looking more closely at individual sectors, we see evidence of both growth and imbalance. Growth by definition improves the supply side of the economy. At the same time, if growth of complementary goods is uneven, quality is poor, or demand grows faster than supply, then imbalances both within and between sectors emerge despite the apparently healthy growth rates. Rapid growth exacerbates these problems when they exist.

In industry, growth rates were higher in 1987 than in 1986, but not as high as in 1985, when China experienced its fastest growth rates since the reforms began. In the first six months of 1985, for example, industrial production had increased 24 percent. Many analysts and officials in China viewed such a high rate with alarm. They feared such high growth would cause serious imbalances and put the reform program in jeopardy. Government controls to slow growth were imposed at the time, with the result that average industrial growth for the year fell to 18 percent. Relatively slower growth followed in 1986, with an annual average of 11.1 percent. Then in 1987 industrial growth began to accelerate once again, reaching 16 percent by mid-year with no signs of slowing in the third quarter. At this point Chinese officials were concerned that a repeat of the much-too-rapid growth of 1985 was possible and that perhaps this problem of overheating was not actually temporary in nature.² In September control measures were instituted that curtailed credit and investment spending. These measures seem to have been effective. By the end of 1987 the annual growth rate was down to 14.5 percent.

Rural industry grew more rapidly than industry overall, with the gross value of industrial output increasing 19 percent to reach 450 billion yuan (\$120.97 billion³). If rural industry is included in the indus-

² *Far Eastern Economic Review*, October 29, 1987, pp. 76-78.

³ using an exchange rate of 3.72 yuan per U.S. dollar.

trial growth figures, then the gross value of industrial output increased 16.5 percent for the year, reaching 1,378 billion yuan (\$370.43 billion). Steel production reached 56 million tons, an increase of 7.7 percent over 1986. Heavy industry increased at approximately the same rate as light industry after a number of years of lagging growth. However, growth in energy (much needed) was mixed. Annual increases in electricity were respectable at 12.3 percent, reaching 500 billion kilowatt hours, but coal output increased only 1.93 percent to 900 million tons, and crude oil increased only 3.3 percent to 135 million tons.

In agriculture, 1987 saw substantial improvements over 1986. Since 1986 was a relatively poor year, however, these increases are not as impressive as they first appear. As with grain, both cotton and oil crops had fallen in 1986 but regained in 1987; cotton increased 10 percent after falling 14.6 percent in 1986, and oil crops increased 12 percent after falling 6.4 percent in 1986. The number of cattle and sheep increased in 1987, but the number of pigs was down, contributing to shortages of pork in urban areas.

Commerce and services generally have received a tremendous boost with the post-1978 reforms. In 1987 this trend continued with an increase of 17.5 percent in retail sales, or a 9.7 percent increase when inflation is taken into account. Leading the way were increases in sales of household items and food. Wholesale business also increased. In 1987 purchases by state commerce departments and supply and marketing cooperatives increased 18.6 percent over 1986. These aggregate figures, however, obscure the fact that supply has fallen seriously behind with respect to goods in high demand such as color televisions, refrigerators, certain textiles, and high-quality goods in general. The shortage of pork, for example, was a shortage in the better cuts of pork, not of pork per se.

Combined increases in wages and credit led to major increases in demand. On average, real wages increased 1.3 percent in urban areas and 3.3 percent in rural areas. While increases in demand due to these real-wage increases alone may have been manageable, additional demand due to credit expansion was not. Credit to rural areas was particularly generous. In the first eight months of 1987 loans outstanding from rural banks and credit cooperatives increased to 285.68 billion yuan (\$76.80 billion), an 8.9 percent increase over the same period in 1986. Credit to rural industry increased almost 40 percent, and loans for farm production were up over 78 percent. Low-interest loans to poor rural areas also increased substantially. Not surprisingly, tighter monetary controls have been proposed for 1988. These increases in credit allowed rapid increases in spending by enterprises,

institutions, and other social organizations. In 1987, as in the last three years, this component of demand increased faster than private consumer spending. Despite high spending, bank saving deposits increased an annual average of 38.7 percent compared with 1986. These deposits represent latent demand that if spent would have increased demand pressures in 1987; they now will be a consideration in estimates for future supply needs.

Current Problems

Despite the fact that the worst fears of overheating did not come to pass, imbalances clearly persisted. Several current problems that relate to, and in some cases exacerbate, these imbalances are the long-term prospects for improvements in grain production, inflation, misguided investment, and poor performance by state industry.

The agricultural sector has continued to be hampered by a slowing of productivity and of output increases in grain production. The good harvest of 1987 was welcomed, but many are concerned about the long-run trend. Increases in investment in the agricultural sector are one solution, and there was some improvement here in 1987. Sales of agricultural capital goods were up 22.4 percent over 1986. But grain prices are low relative to many cash crops, and fertilizer prices have been rising. Chinese analysts argue that these trends have discouraged expansion of grain production. Other problems that have serious long-term consequences are the worsening fertility and erosion of land, decreases in land devoted to agriculture, inadequate infrastructure, and a lack of organizations serving agriculture.

Grain prices may have been stable, but the average price level was not. After an official inflation rate of 6 percent in 1986, inflation continued to rise in 1987, albeit modestly, to an official rate of 7 percent. Although not a high rate by other countries' standards, it causes concern in China, especially because the official rate is often too optimistic, and Western analysts estimate the inflation rate to be closer to 15 percent. Even the more optimistic official figure for average increases in urban retail prices is over 10 percent, and for some foods it is as high as 35 percent. As a result, by the end of the year, after two years of decontrolled meat distribution, pork was again being rationed in Beijing, Shanghai, and Tianjin, and sugar was being rationed in Beijing. Reflecting concern that the problem may worsen, in October China began a nationwide investigation into possible illegal price rises, underpayment of taxes, and profiteering.

Rapid increases in investment in 1987 contributed to the government's problems with inflation and macro imbalance. Investment in-

creased in energy, transportation, and irrigation, all-important sectors where it was badly needed. However, overall investment increased much more than was called for by the plan. When total investment exceeds planned levels it contributes to shortages of materials, adds inflationary pressure, and slows completion of all projects. In addition, excess investment is typically a result of relatively small, non-priority projects. Approximately 90 percent of the new investment projects started in 1987 entailed investments of less than a million yuan (\$0.26 million). Although these projects are small, the sums involved add up. At mid-year, fixed asset investment in state-owned enterprises alone, that is, not including collective and private investment, had increased 21 percent more than during the same period of 1986, and capital-construction investment had increased 19.3 percent. In response to the over-ambitious mid-year investment levels, the state cancelled or postponed a number of projects, managing to reduce the increases in fixed assets to 14.2 percent for the year and to 13.9 percent in capital-construction investment. While these cuts successfully slowed investment growth, it is likely that they disproportionately affected major planned state projects, projects over which the government has the most control. Total investment, including state, collective, and private projects increased 16.5 percent, reaching 351.8 billion yuan (\$94.57 billion). While this annual increase in total investment was lower than the 18.7 increase in 1986, Chinese officials still consider it to be too high.

Another major problem area for China's economy in recent years has been the poor performance overall of state enterprises. For a number of years output growth and profit levels of state-owned enterprises have increased much slower than those of the collective sector. In industry, for example, in the first half of 1987 industrial output of state enterprises increased 10.2 percent over the same period of 1987, while collective industrial output increased 22.9 percent.⁴ In 1986 state industrial output increased only 6.2 percent, while collective industrial output increased 16.7 percent.

Before 1979 collectives were at a disadvantage relative to state enterprises. Because they were only secondary to the state plan, collectives often had difficulty obtaining inputs, financing, and sales at fixed prices. While state enterprises were covered by the plan, the collective sector was expected to decline as socialism advanced, and therefore its survival was not a priority. In the post-1978 period of reform, however, the state sector's previous advantages in access to inputs, financing, and guaranteed sales has been eroded as markets have

⁴ *Far Eastern Economic Review*, August 6, 1987, p. 52.

increasingly supplemented the plan. Flexibility in output mix, input sources, and pricing have become crucial to an enterprise's ability to respond to changing market conditions, and while collective enterprises have proven adaptable, state enterprises have little experience in such matters. Meanwhile, planners continue to rely on state enterprises to guarantee a minimum production level for important goods. Once planned output levels have been met, enterprises are supposed to use their excess capacity profitably. Managers of state enterprises who are neither used to making their way in markets nor given adequate reign to do so, face a difficult task: state enterprises now serve as the last remaining pillar of the old planned system, but simultaneously must meet the demands of a new, semi-market system that is the product of piecemeal reforms.

The problems facing state enterprises are severe. Their profits are often squeezed as they purchase inputs at high market prices but sell their output to the state at relatively low, fixed prices. In the case of steel, for example, the state price is 800 yuan per ton compared with a market price of 1,500 yuan or more. Because inputs supplied by the plan are usually inadequate even to produce the planned portion of output, sales of the above-plan output at higher, market prices often are inadequate to cover rising input costs. Furthermore, enterprises are under pressure from workers to raise wages since wages have risen elsewhere in the economy. As of September the wage bill of state enterprises had increased 16.7 percent, contributing to increased costs of production. Inflation, of course, exacerbates these problems. The result is an incentive, albeit illegal, to under-fulfill the state plan, selling as much output as possible for higher, market prices.

Another problem facing state enterprises is that despite the fact that managers have been given more decision-making power in principle, in practice managers have not had much leeway to decide output mix, to hire or fire, or to implement linkages between remuneration and worker performance. When managers decide to break with past practices they take the risk, for example, of angering workers or endangering relatively secure supply arrangements. The incentives are not high enough to encourage managers to take the risks involved in trying new production or management methods. For example, managers who earn incomes that are high relative to those of the workers are either criticized in the press or subject to regulations limiting earnings differentials. While this may not deter all managers, such criticism and regulations will tend to keep the differentials small and to add to the uncertainty of where such reforms will ultimately lead politically.

Reform in 1987: Proposals and Progress

China's post-1978 reform program began in the agricultural sector. In recent years the focus of reform has moved to industry, and in 1987, to state industrial enterprises in particular. Attempts to improve incentives and to increase connections between sectors have also been made through taxation and pricing changes. All of these reforms have been aided by an accepted retreat from socialized production. For example, in agriculture families now contract directly with the government to sell their output in return for using land, rather than working with other households in collectivized production. Small, privately run commercial and service enterprises have been allowed to increase rapidly. As of June 1987, the private sector accounted for 82.7 percent of the commercial and service businesses and handled 13.2 percent of the total retail volume. Collective enterprises have also made a comeback and are now encouraged to compete with state and private enterprises. China's official position is that multiple forms of ownership are valuable—and inevitable—while China is in its current stage of primitive socialism. This interpretation was solidified at the Thirteenth Party Congress in October.

In addition to encouraging different forms of ownership, another principle of reform allows for the separation of ownership and management. This separation is crucial to reform in agriculture, for example; although all land is state-owned, individual families now are making decisions concerning the use of land. In state industry this approach is necessary because if managers are to have autonomy in economic decision making, the input of Party officials and economic ministries overseeing the enterprises must be lessened. Several issues concerning the progress of reform in 1987 are best understood in this context.

The Separation of Ownership and Management

Four categories of reforms that were important in 1987 further separate management from ownership. These are manager responsibility, issues surrounding enterprise funds, enterprise sales of stocks and bonds, and land sales. These will be discussed in turn.

At the beginning of 1987, 40 percent of state-owned enterprises reportedly were using a manager-responsibility system. Throughout 1987 the other 60 percent were encouraged to do the same. In the context of China's attempts to reform, manager responsibility refers to a shift in decision making from state planners to managers of state enterprises. This system is designed to expand managers' flexibility in running an enterprise, and it is also a way to lessen Party involve-

ment in the daily operations of enterprises and to provide incentives to increase production while reducing costs. Managers' performance is evaluated by a committee made up of members of an enterprise's Party committee, trade union, and worker congress. This evaluation is based on performance indicators such as improvements in productivity and profitability and the firm's ability to meet its contracts. Managers' salary increases are then tied to these performance criteria.

In theory, manager responsibility is essential as more of the economy becomes market oriented and less is planned. But while managers' responsibilities are being increased significantly, improvements in autonomy continue to be problematic. Since the enterprise committee's role goes beyond consultation to having the authority to supervise and evaluate the manager, it remains to be seen whether true autonomy is possible. This system may weaken the input of the Party, but whether such a committee, which represents several interests, would be easier to deal with probably varies from enterprise to enterprise.

A more radical form of manager responsibility currently being tried is that of leasing state-owned enterprises, or even outright sales of property rights, to individuals or groups of individuals who mortgage funds in return for the right to run the enterprise as they see fit, taking the resulting profits or losses. This reform has so far been tried primarily in small, service-oriented state enterprises. Leasing avoids the potential compromises in autonomy that may result under a supervising committee because there is no such committee. The problem of insufficient incentive, i.e., inadequate salary, is also avoided since there are fewer restrictions on lessees earning high incomes. But leasing also takes separation of ownership and management one step further than the adoption of the more general form of manager responsibility. The Chinese press often has warned of the consequences for socialism if leasing were extended to large, important enterprises, which would, in their opinion, erode the very foundations of socialist ownership "by the whole people."

The probability of either of these manager-responsibility systems improving the efficiency of the enterprises is partly dependent on what happens when an enterprise loses money and on whether enterprises have sources of funds independent of the offices that oversee their activities.

Pressures on systems of responsibility are created when enterprises do not make profits. To achieve true autonomy and make responsibility effective, enterprises must be held accountable for losses through corrective financing arrangements or bankruptcy. In the past when enterprises could not repay loans, or when they were not profitable,

the government budget absorbed the loss. A reform designed to lessen this burden on the government was proposed in 1987 to begin sometime in 1988. This reform, referred to as "double accounting," would explicitly identify sources and uses of funds as state funds or enterprise funds. Then, if an enterprise incurred a loss with the state, it would be required to use its other funds to repay that loss. In this way an enterprise incurring losses in its transactions with the state could not, for example, simultaneously be using its own funds for investment.

If an enterprise continues to lose money, then bankruptcy is the next logical step. If there is no possibility of failure, then managers know that even if losses persist, government funds always will come to the rescue. But bankruptcy is an alien concept in a socialist economy where enterprises are publicly owned. Even if bankruptcy is written into law, the experience of other socialist economies suggest that it will be seldom used. The costs of unemployment, disillusioned workers, and idle equipment are just too great. Many in China argue that at the very least a welfare or unemployment benefit system is needed before bankruptcy can be taken seriously.

Another proposed reform that would provide an alternative source of funds for enterprises is the establishment of a capital-construction, or investment, fund. This fund would be for investment projects other than major, long-term state projects covered by planned investment. How this fund would actually work is still vague at this point, but the principle appears to be one of instituting a central source of funding, other than bank loans, for small and medium-size projects. The reliance on bank loans for these types of projects has resulted in an over-issuance of credit. Through centralization, the fund would be less vulnerable to local interests and could better control credit expansion. The fund would also coordinate requests for investment to avoid duplication of investment projects within localities and to aid balanced development among the sectors of the economy. The implementation of this type of fund would weaken the connection between enterprises and the specialized ministries and local officials upon which the enterprises have been fairly dependent for investment funds as well as for allocations of inputs. This change would be particularly helpful to enterprise associations, which are groups of enterprises whose members belong to different administrative levels and geographic areas. Associations do not directly benefit any one locality, a fact that now weakens their ability to gain access to loans, inputs, and markets. Along these lines, the central government announced in October that it would begin distributing funds for research in technology development directly from the State Science and Technology

Commission to enterprises and individuals instead of giving these funds to ministries and local officials to disperse.

Another source of funds affected by the separation of ownership and management is the issuance of bonds or the selling of shares in an enterprise. Through such equity sales the buyers are actually acquiring assets, or claims on assets, that they and the rest of the public already technically own. This problem does not arise with collective enterprises, and to date equity sales have been more common in the collective sector. Nonetheless, state-enterprise issues occurred throughout 1987, and at the Thirteenth Party Congress Zhao Ziyang reaffirmed that this practice would continue on a trial basis. The existing stock market is far from a daily operation, and only four official issues of state-enterprise stocks have been made since 1985. However, this underestimates the number of enterprises involved in issuing stocks and bonds. Reportedly, in Shanghai alone, over 1,500 enterprises have raised funds in this way. Regulations concerning issues are in effect, including the percentage of the capital stock value that can be sold, but private individuals as well as other enterprises are allowed to purchase these assets.

Land sales have also occurred. In September the Special Economic Zone of Shenzhen held its first land auction, offering land-use rights for 50 years, with transfer and mortgage rights included.⁵ Shanghai is interested in using such sales to raise capital for development, but so far this special right permitted in Shenzhen has not been extended to other parts of China. At the same time, Chinese enterprises that want to expand their production facilities often seek out rural areas in which to build factories or take over and convert existing facilities. Rural communities receive some financial return for allowing enterprises use of the land. Economic concerns aside, these practices challenge established notions about socialist state ownership and control of valuable resources such as land; in principle land sales and leasing are forbidden by the constitution. How widespread these practices become therefore will depend in part on whether they can be reconciled with the theory of socialism.

Price and Tax Reform

Many analysts believe that the key to the success of China's economic reform program is price reform. For example, since the profit level of an enterprise is directly influenced by prices, unless relative prices reflect production costs and user demands, enterprise-

⁵ *Far Eastern Economic Review*, October 15, 1987, pp. 82, 84.

responsibility systems will be ineffective in producing a more efficient use of resources. In fact, increased responsibility may only exacerbate the problems that may attend true decentralization of production and investment decisions. However, if price reform were instituted, thereby radically changing relative prices throughout the economy, it would affect income distribution throughout the economy in a way that could upset the political status quo. The daunting complications of working out a smooth transition have left price reform primarily in the realm of study rather than official implementation.

Meanwhile, changes in relative prices are occurring as the proportion of output produced for the plan and sold to the government falls. While the price of output bought by the state is fixed, output produced beyond this, or commodities that are no longer part of the plan, can be sold at negotiated or market prices. Depending on supply and demand, these prices could be higher or lower than state prices. The tendency, however, has been for prices to rise, contributing to rises in the average price level. Whenever the rate of inflation rises, pressure to control prices emerges in conjunction with a reversion to rationing.

Although the price issue is politically sensitive, price reform *per se* is apparently not being blamed for the current round of inflation. A new study on a possible next step in price reform was released in October 1987, although no date for implementation was mentioned. Under this proposed system, actual prices would not be affected directly. Instead, internal accounting prices, or "policy prices," would be established according to estimates of relative resource scarcities done by the United Nations and the World Bank. These policy prices would then be used by banks and officials of the Ministry of Finance, and presumably by the proposed construction fund, to rank investment projects and to decide appropriate tax rates. Policy prices would also be used by enterprises to assess the economic feasibility of projects and to measure progress toward improving productivity. Since part of China's investment problem is created by misaligned prices that can encourage investment in the wrong sectors—for example, in artificially high-profit breweries instead of low-profit energy—use of these internal prices would be an immense help. The success of using such internal prices, however, would depend on enterprises believing that actual prices would eventually move in the direction of the policy prices. There would also have to be sufficient means to control investment costs by delaying investment in projects for which, using the policy prices, the cost was too great until such time as the policy and market prices converged.

A change in the investment tax has been proposed to help control investment until investment costs accurately reflect resource costs. There has been a 10 percent tax on investment since 1983, but this tax was applicable only to investment of funds allocated through the state budget and from bank loans. Local government investment and projects funded by non-budgetary enterprise funds were exempt. Changes will be instituted in 1988 to raise the price to enterprises of non-planned investment. This will decrease over-investment caused by the availability of funds at artificially low costs without having to rely solely on an approval process. Beginning in 1988 investment will be subject to three tax rates of 10, 20, and 30 percent, applicable to all types of investment funds except key projects approved by the central government. Priority projects such as technological improvement will be subject to the lowest tax, and "nonproductive" projects such as hotels and office buildings will be taxed at the maximum rate.

International Trade and Investment

For the last several years China has imposed strict controls on imports in order to decrease its trade deficit. In 1985 the trade deficit was \$14.9 billion, and in 1986 it improved only slightly to \$12 billion. In 1987 very strict import controls were continued and were even extended to important capital goods, which no doubt added to inflationary pressures as enterprises attempted to find substitutes where possible. However, these controls led to an overall decrease in imports. Simultaneously, exports were promoted. In the first nine months of 1987 exports increased 23.9 percent over the same period of 1986. China has also been quite successful in altering the composition of its exports away from raw materials and processing to high value-added goods such as footwear, toys, sporting goods, and mechanical and electrical goods.⁶

China's successful export promotion, however, has come at a price to the national budget in the form of export subsidies. As this is not sustainable, and as China prefers to maintain a near balance in trade, new proposals to reform the trading system were released in 1987. In the past, decentralization of international trading and control of foreign exchange resulted in rapid increases and duplication of imports which worsened the trade deficit. This time the thrust is to coordinate enterprises within the same industry to prevent price-cutting competition between them and to pool their knowledge and resources to help them crack foreign markets. A group of enterprises that trade in light

⁶ *China Business Review*, March-April 1987, p. 30.

industrial goods, handicrafts, and garments will be selected to experiment with a responsibility system in trading. They will be given the right to retain foreign exchange as a reward for increasing exports and profits. In order to encourage exports of highly processed goods, the percentage of foreign exchange that can be retained by the enterprise will be higher when the level of processing involved is higher. Targeted enterprises also will receive some state funding to upgrade facilities and will receive priority with respect to needed inputs.

After a major decline in 1986 foreign investment in China rebounded in 1987. In the first half of the year 738 joint-venture contracts were signed, representing a 30.4 percent increase over the same period of 1986. Actual investment in the first six months was \$500 million, an increase of 14.5 percent. Since 1979 contracts worth \$17.1 billion have been signed, and actual foreign investment has reached about \$5 billion. In addition, off-shore oil contracts worth \$2.86 billion have been signed; service and engineering contracts currently total \$6.37 billion; and loans for \$20.7 billion have been made for construction of industrial and infrastructure projects.

Several changes were implemented in 1987 to help foreigners do business in China. First, the tax on wage and salary income earned by individual foreigners in China was reduced by 50 percent. Second, to help mediate when problems arise, the State Economic Commission set up the Coordinating Center for Business Co-operation. It is unclear how supportive or efficient the center will prove to be, but perhaps its very existence will lend credence to complaints filed by foreign companies. Up until now, if foreign companies felt contracts had been misinterpreted or broken, they had little recourse but to threaten lawsuits, which were ineffective given China's nearly nonexistent legal system. Furthermore, with no specified part of the bureaucracy taking responsibility for such problems, their Chinese counterparts had little reason to fear reprisal. Third, a new Trust and Investment Corporation, technically falling under the jurisdiction of the People's Bank of China, was established by the Ministry of Foreign Economic Relations and Trade. This corporation has a sizable capital base and will deal with foreign-exchange investments and loans.

Evaluation: Future Prospects for Raising Living Standards

Despite uncertainties concerning the socialist nature of some of China's reforms and macro imbalances, household income and consumption levels have clearly risen. Household surveys periodically carried out by various Chinese research groups give some indication of the improvements in income that have occurred since the reform

program began. One survey covering 66,000 rural households in 846 counties found that in 1978, 33.3 percent of households earned less than 100 yuan in annual net income per person, while in 1986 this percentage had dropped to 1.1 percent. In 1978, 2.4 percent of the households in this survey earned more than 300 yuan per person in net annual income, and by 1986 this percentage had increased to 66.9 percent. Another survey found that in urban areas in 1981, 6.5 percent of the households earned 60 yuan per person per month, or 720 yuan per capita annually, while in 1986 this percentage had increased to 63.4 percent. Along with improvements in income, there is ample evidence of improved consumption levels as households increasingly desire high-quality and expensive goods. Rising rates of saving indicate that people willingly wait to purchase the high-quality goods they desire.

These increases in living standards have contributed to widespread support for the reform program. Several trends, however, may be working against future increases in living standards in both rural and urban areas, and without those increases support for the reforms could erode.

One such trend in rural areas is that the prices of inputs such as fertilizer are rising at the same time that growth in agricultural output is slowing compared with the initial years of rural reform. Some analysts in China feel agricultural purchasing prices should again be raised to compensate for these cost increases and to serve as incentives to increase production. Others disagree, arguing that after a number of years of budget deficits, the government cannot afford higher purchasing prices. This group tends to favor decontrolling distribution of agricultural products altogether, including grain, and letting the market determine the price. Even if prices rise enough to stimulate incentives to produce more, the question for agricultural workers in China will be how to raise output while keeping expenses at a minimum. For example, are there further gains to be made from reorganizing production? Will more use of fertilizer make a difference? And what kinds of long-term investments should be made? Chinese analysts agree that rural reform needs to be revitalized in 1988, but a consensus is lacking on what should happen next.

Second, working against the future standard of living in China are trends in population and education. China's rate of population growth is again on the rise, especially in rural areas. Between 1985 and 1986 the birth rate increased from 17.8 per thousand to 20.8 per thousand. Stricter enforcement of the one-child-per-family policy has been announced for 1988, but progress will not be easy. The success of the rural reforms themselves is partly to blame for the slippage in

population control. The prospects of higher income through higher production, and consequently the desirability of having more family members to help, have outweighed the social or financial costs of ignoring the population policy. For similar reasons, increasing numbers of rural children are not finishing even the minimum of education required. While the extra family workers are contributing to current increases in family income, these trends may have negative effects on increases in average family income in the future if, as some studies indicate, education levels correlate to improved skills and lower fertility.

Third, the problem of inflation eroding increases in living standards is particularly relevant for urban residents. As noted earlier, inflation in the cities has been consistently higher than the average; it was as high as 35 percent with respect to food prices in some areas during 1987. Because average wages have been increasing, inflation will be at least affordable for some, but others will not be so fortunate. Wage increases vary by work unit depending on whether or not the enterprise is profitable, and although they are high in some cases when bonuses are included, they rarely match the 35 percent inflation rate. Wages of workers who have temporary contracts with enterprises are not likely to keep up with inflation unless a worker has a special skill in high demand. Expanding the labor-contract system is part of the reform program, which is meant to develop a labor market in China, giving both workers and enterprises more choice in employment. The trade-off for this flexibility, however, may be decreases in wages, benefits, and job security. If wages of these workers increase slower than those of permanent workers, then expanding this system will bring down the average wage. Finally, people on fixed incomes will be especially unhappy with the adverse effects of inflation on their real incomes.

A major contributing factor to inflation in urban areas is rising housing costs, which are the result of changes in the way housing is distributed and managed. Housing costs to consumers have been extremely low. Monthly rent has been estimated to be less than one yuan in some areas, far below the costs of maintenance, let alone the costs involved in building new apartments. With reform, rents for existing housing are to be gradually increased and adjusted to account for the amount of floor space; residents will be encouraged to purchase their apartments; and rents or purchase prices for new apartments will reflect the building and maintenance costs. While these proposals are designed to deal with the serious housing shortage, they will also lead to substantial increases in monthly expenses for urban residents.

So while individuals have seen impressive increases in their incomes with reform, further increases in living standards are likely to be more modest. In itself this need not weaken the momentum for reform, for there is still no comparison with the pre-reform period when wages stagnated, but efforts to raise public understanding concerning these adverse trends will become increasingly necessary.

Issues concerning income distribution have also created some confusion. Although prosperity was not the norm before 1979, austerity created relatively equal income distribution. Since 1979 Party and government officials have condoned less equal distribution, in part to introduce material incentives into the system and in part because this was inevitable once reforms began. Unequal income distribution is nonetheless a sensitive issue. This is especially true if some people's prosperity is due to unearned income from owning assets, which compromises the socialist principle of "to each according to his work" and gives those who are less prosperous a legitimate complaint.

The government position on income distribution has been to accept worsening inequalities as long as incomes are earned legally. A hierarchy of wages is maintained; for example, managers earn more than the workers they supervise. The government has also been concerned about the low incomes of those who live in China's northwest and southwest, where the land is barren and the climate is difficult. Per capita annual average income in these areas is estimated at less than 200 yuan (\$54), compared with an annual average of 424 yuan (\$114) in other rural areas and 1,600 yuan (\$430) for workers and staff in non-agricultural jobs. Some of the government's efforts to improve the incomes of these people include moving them to more hospitable environs, supplying subsidized loans to develop local employment opportunities, and seeking additional aid specifically for the poorest areas from international agencies like the World Bank.

Conclusion

After much uncertainty with respect to both the future of China's reform program and its ability to control runaway growth, 1987 ended on a surprisingly positive note. The Thirteenth Party Congress proclaimed China to be in the "primary stage of socialism," allowing flexible interpretations of reforms, and labeled 1988 the beginning of the third stage of reform. Despite problems due to the "trial and stage" approach to implementation, the current and proposed reforms primarily reinforce each other and attempt to confront the problems at hand. For example, enterprises need access to funds to achieve the much-sought-after autonomy; the stock and bond markets and the

proposed construction fund address this concern. At the same time, central officials need some way to influence the use of such funds; both the extension of the investment tax, which discourages investment by raising its cost, and the use of the proposed "policy prices" as the basis for project selection address this issue.

With respect to growth, unreasonably high growth rates occurred during 1987 in some sectors but were lower by year's end. The decent harvest, an easing of the trade deficit, and equal growth rates in heavy and light industry will all help correct demand and supply imbalances.

Many problems remain, of course, with inflation being one obvious reflection of these problems and perhaps also a key obstacle to timely implementation of further reform. Concerns over whether or not imbalances will worsen in 1988 are being expressed by Chinese analysts and officials at all levels. Many reforms are still in an experimental, trial stage, and it is unclear when, if ever, they will be implemented more generally. The bankruptcy law, for example, has not appeared lately in official discussions of the future of China's economic reforms, and Zhao Ziyang did not mention it in his pivotal speech at the Thirteenth Party Congress.

Reflecting concern with rapid, imbalanced growth, plans for 1988 emphasize results and not speed. Reform work is to focus on improving investment decisions, input distribution, the international trading system, and wage and personnel options in enterprises and in civil service. The next step in rural reform is under discussion.

The combination of new political leadership and persistent economic problems leaves the Chinese economy in 1988 with a delicate balance of high expectations and an uncertain political and economic environment. To some extent progress with respect to economic reform has been placed on the shoulders of enterprise managers. But in any economic system, managers perform least well in uncertainty, and in China this is only compounded by the still-vague division of authority between managers and the political cadre. Finally, with the appointment of Li Peng to replace Zhao Ziyang as acting premier, the priorities with respect to reform could change. Li, trained in the Soviet Union as an engineer and raised in the center of power as Zhou Enlai's adopted son, may favor slower implementation of market autonomy and decentralization of enterprises. Reform, both economic and political, has been reaffirmed by the Party Congress; how this translates into action in 1988 remains to be seen.